The Honorable Nick Khouri
Austin Building
430 W. Allegan Street
Lansing, MI 48922

Dear Treasurer Khouri,

A December 12th memo ("Memo") from the Michigan Department of Treasury (Treasury) highlights the concerns with H.B. 1170, legislation moving though the Michigan legislature that would grant Michigan partnerships and S corporations ("flow-through entities" or "FTEs") an election to pay tax at the entity level on their Michigan business income.

The purpose of this election is to respond to changes made in the federal Tax Cuts and Jobs Act (TCJA) and restore the ability of Michigan flow-through businesses to deduct their State and local taxes on their federal tax returns. The Conference Report to the TCJA clearly indicates that taxes imposed at the entity level will be deductible. H.R. Rep. No. 115-466, at 260 n.172 (2017) ("[T]axes imposed at the entity level, such as a business tax imposed on pass-through entities, that are reflected in a partner's or S corporation shareholder's distributive or pro-rata share of income or loss on a Schedule K-1 (or similar form), will continue to reduce such partner's or shareholder's distributive or pro-rata share of income as under present law.") Treasury has estimated that this legislation would save Michigan businesses $190 million per year on their federal taxes with no intended revenue cost to the state.

The concerns raised in the new Memo suggest that the elective nature of H.B. 1170 might make the FTE tax "voluntary" and increase the odds the law is challenged by the I.R.S. As the Memo states:

> *As introduced, HB 1170 creates an elective income tax for flow-through entities in Michigan. This new tax is designed to preserve the benefits of an unlimited federal state and local tax (SALT) deduction for individual flow-through entity members, which was recently capped at $10,000 under the federal Tax Cuts and Jobs Act. Any flow-through entity tax is likely to receive close scrutiny from the IRS. In this regard, Tax Policy has concluded that the intended SALT deduction benefits of a flow-through entity tax are at a great risk of being challenged by the IRS, especially so if the tax is elective.*

To support this concern, the Memo makes four key points:

1. The election makes the tax imposed under H.B.1170 "voluntary" and undermines the necessity that the tax be an enforced contribution;
2. The "all events" test of IRC §461 does not change the voluntary nature of the tax imposed in H.B. 1170;
3. The concept of a flow-through entity tax has made the IRS "top 10" list for future regulations; and

4. HB 1170 is far more vulnerable than Connecticut because it stands alone among states as a voluntary tax.

None of these arguments are valid and they should be disregarded when considering the merits of H.B. 1170. The tax imposed under H.B 1170 is *not* voluntary; Treasury misstates the "all events" test; the IRS has *not* targeted the "flow-through entity tax" in its planned guidance; and Michigan is *not* the only state with an elective entity tax, proposed or enacted. This Memo will address each of these false assertions in full.

<u>A "Voluntary" Tax? No.</u>

The Memo argues that "there are strong arguments that the payments made under the flow-through entity tax are not a "tax" under IRC 164," but then the Memo fails to make any of those arguments.

Instead, the Memo notes, "the IRS views payments as a tax under IRC 164 only 'if it's an *enforced contribution*, exacted pursuant to the legislative authority in the exercise of taxing power'" (emphasis in original). Treasury then argues that the elective nature of the entity tax in H.B. 1170 makes it "voluntary" and therefore somehow disqualifies it as a tax under IRC §164. This is not correct, both under the conditions outlined in IRC §164 and with regard to other elections found in the IRC.

Under H.B. 1170, once an election under new Section 757 is made, the FTE tax is an "enforced contribution." If the electing FTE failed to pay, you may rest assured that the Department would not hesitate to exercise Michigan's taxing authority to levy and collect the FTE tax from the recalcitrant S corporation or partnership.

Furthermore, there's nothing about an election that somehow disqualifies the payment as a "tax". There are numerous elections and other options under the IRC and state tax laws that trigger tax, yet we are unaware of any I.R.S. or court ruling taking the position that those elections cause the tax thereby triggered to be voluntary or optional and, therefore, not deductible.

Many of these elections apply in the S corporation area. For example, many states allow corporations to elect out of S corporation status for state tax purposes, and thereby subject themselves to state income tax. Such taxes at the corporate level obviously qualify as §164 fully deductible state income taxes for such corporations.

The Internal Revenue Code itself contemplates such elections. IRC §1362(b)(1)(B) allows taxpayers to elect retroactively out of S corporation status, thereby triggering tax at the corporate level, typically at both the state and federal levels. Any state income taxes thereby triggered at the corporate level are fully deductible for federal purposes. IRC §1368(e)(3) and §1371(e)(2) of the Code allow S corporations to make an election on their corporate income tax returns to treat distributions as taxable dividends from accumulated C corporation earnings and profits (rather than tax-free distributions of S corporation income). Again, no one has taken the position any state income taxes thereby triggered at the individual level were not deductible state taxes.

<u>IRC 461 Does Not Apply</u>

The Memo's interpretation of the §461(h)(4) all events, economic performance test is fundamentally flawed. IRC §461 is a timing provision, not a disallowance provision. There is no question that, for an electing FTE that pays the tax thereby imposed, "all events have occurred that established the fact of the liability," "the amount of the liability can be determined with reasonable accuracy," and "economic performance has occurred." As explained below, FTEs should be eligible to deduct this new FTE tax on a timely basis under the recurring item exception, but there are simply no reasonable grounds to assert that §461 could somehow disallow the deduction entirely.

Moreover, the Memo incorrectly attempts to combine the economic and tax results of the "business" and its owners, arguing:

> *Since the net economic value from the business operations stays the same for the owners regardless of which person pays the state tax, it is questionable that the third prong of the IRC 461 "all events" test could be met.*

This analysis is wrong. There is absolutely no requirement to *combine* the economic and tax results of an S corporation and its shareholders, or a partnership and its partners, when testing the validity or timing of a deduction under the §461(h)(4) all events test. If the tax is imposed at the entity level, it is an entity liability; if the tax is imposed at the individual level, it is an individual liability. It's that simple.

The Memo focuses upon the third prong of the §461 test, namely the economic performance test. Reg. §1.461-4(g)(6)(i) states that "if the liability of a taxpayer is to pay a tax, economic performance occurs as the tax is paid to the governmental authority that imposed the tax." However, the recurring item exception of §461(h)(3) provides that an item shall be treated as incurred during any taxable year if:

1) The all events test, notwithstanding economic performance, is met during such taxable year;
2) Actual economic performance occurs within the shorter of:
    a) a reasonable period after the close of such taxable year; or
    b) 8 ½ months after the close of such taxable year.
3) Such item is recurring in nature and consistently treated by the taxpayer, and
4) Such item must be either:
    a) not a material item; or
    b) the accrual of such item in the taxable year results in a more proper match against income than accruing such item in the taxable year in which economic performance occurs.

When a Michigan S corporation or partnership irrevocably elects into the Michigan Part 4 FTE tax prior to the end of its taxable year, the first two prongs (fact of liability and amount determined with reasonable accuracy) of the all events test will be met during such year. Actual payment of the FTE tax must be made within 8 ½ months to qualify for this recurring item exception. The accrual of the FTE tax in the taxable year generating the taxable income upon which the FTE tax is computed is clearly a more proper match than accruing the FTE tax in the year of payment. Since the FTE tax is subject to an election by the S corporation or partnership into the tax, a question might arise as to if it would meet the "recurring in nature and consistently treated by the taxpayer" test? Guidance is provided by Reg. §1.461-5(b)(3) which states:

> "A liability is recurring if it can generally be expected to be incurred from one taxable year to the next. However, a taxpayer may treat such a liability as recurring in nature even if it is not incurred by the taxpayer in each taxable year. In addition, a liability that has never previously been incurred by a taxpayer may be treated as recurring if it is reasonable to expect that the liability will be incurred on a recurring basis in the future."

H.B. 1170 provides that the election is irrevocable for the year of election and the subsequent 3 years. Thus, the Michigan FTE tax should be considered as recurring even if it is not incurred by the taxpayer in each elected year due to losses, because it will be incurred during any of the four years covered by the election as long as there is positive business income. The last sentence of Reg. §1.461-5(b)(3) provides authority for a first year MI FTE taxpayer to treat it as a recurring item in the first year of election.

There simply is no basis for arguing that §461 would somehow disallow the deductibility of the H.B. 1170 FTE tax.

IRS Top Ten? No.

It is also incorrect to claim, as the Memo does, that the "flow-through entity tax" made the IRS "top 10" list. The IRS has noticed that it intends to issue guidance on how to apply the SALT limitation to pass-through business income, but what that guidance entails remains to be seen. The description of the potential guidance -- "Guidance on applying the state and local deduction cap under §164(b)(6) to passthrough entities" -- is neutral with respect to the policies embraced in H.B. 1170 and could include any number of issues unrelated to the FTE tax at issue here.

Indeed, in comments to stakeholders, the I.R.S. has made clear that clarity is needed in order to ensure that only a "trade or business" may continue to deduct State and local taxes paid at the entity level. That issue pivots on whether a business claiming the deduction is really a "trade or business" under the IRC, and therefore entitled to the deduction. That question is wholly separate from the policies under consideration in H.B. 1170. Similarly, there is a question as to whether composite taxes paid on behalf of shareholders or partners might be deductible at the entity level. That issue too is unrelated to the proposed new Michigan FTE tax.

Michigan Stands Alone? No.

The Memo argues that Michigan is alone in considering an elective FTE tax, with the implication being that Michigan is somehow out of the mainstream of state reforms, despite the fact that the only other state cited by the Memo is Connecticut, which earlier this year adopted a similar reform save for the fact that the Connecticut FTE tax is mandatory.

The Memo is correct that the Connecticut reform includes a mandatory FTE tax, but it is incorrect that Connecticut is the only other state taking action, or that Michigan is alone in considering an elective tax. Just last week, the Governor of Wisconsin signed legislation creating a FTE tax for Wisconsin pass-through businesses. As with H.B 1170, this tax is elective. Other states considering similar taxes include New York and Arkansas.

The new law in Wisconsin and under active consideration in several others should spur significant interest in this reform. We expect to see any number of states take up this reform in the coming legislative session.

Conclusion

The arguments made in the Memo fail to stand up to scrutiny. Treasury should set these concerns aside and help Michigan restore parity to the 250,000 Michigan businesses organized as S corporations and partnerships. As Treasury has estimated, this reform would reduce their federal tax burdens by $190 million per year, with no intended cost to the state. As the bill's sponsor has made clear, this legislation is a win-win for Michigan and the businesses that operate here.

Sincerely,

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